

**DEPARTMENTS OF COMMERCE, JUSTICE, AND  
STATE, THE JUDICIARY, AND RELATED  
AGENCIES APPROPRIATIONS FOR FISCAL  
YEAR 2004**

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**TUESDAY, APRIL 8, 2003**

U.S. SENATE,  
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,  
*Washington, DC.*

The subcommittee met at 10 a.m., in room S-146, the Capitol,  
Hon. Judd Gregg (chairman) presiding.

Present: Senators Gregg and Hollings.

**SECURITIES AND EXCHANGE COMMISSION**

**STATEMENT OF WILLIAM H. DONALDSON, CHAIRMAN**

**OPENING STATEMENT OF SENATOR JUDD GREGG**

Senator GREGG. The committee will come to order. It is great to have the Chairman of the SEC here today, William Donaldson.

First, I want to thank you on behalf of the Congress and the American people for being willing to come out of the private sector, with your tremendous experience and expertise, and take over this job. I consider it to be one of the most significant jobs we have in the Federal Government because it is the job which makes capital markets vibrant and reliable, and capital markets which are transparent and properly regulated are critical to the well-being of the American economy.

International confidence in our markets is essential to the survival of our Nation and our free market system, so having your leadership at the SEC is crucial, and we are excited you are there.

Senator, did you have any opening comments?

Senator HOLLINGS. I am equally excited and grateful that he would take this assignment. Thank you.

Senator GREGG. We would be happy to hear any thoughts you have to add. You can summarize your statement or read it, however you wish to proceed.

**OPENING REMARKS**

Mr. DONALDSON. Thank you for your comments, Senator. I am honored to be here and to be in the position I'm in. Let me just make a couple of brief comments, and then we can do whatever you would like in terms of carrying on from there.

I appreciate the chance to speak. Our request is for \$841.5 million. That's the largest amount that's ever been requested for the SEC, and it comes on the heels of last year's appropriation, which was the largest single year percentage increase ever provided the Commission. I want to thank you and the subcommittee for the tremendous support and leadership you've shown in ensuring that the Commission receives the resources that are necessary to fulfill our mission.

Thanks to your efforts, the Commission has been appropriated \$716.4 million to fund its operations this fiscal year as part of the omnibus appropriation. These funds will enable us to meet the remaining deadline for the Sarbanes-Oxley Act, hire over 800 new staff and advance the initial startup funds to the Public Company Accounting Oversight Board, improve our training efforts, and address our most pressing information technology needs.

Ensuring that our new resources are used to promote the effectiveness and support the modern mission of the SEC, rather than simply increasing our numbers, is one of my most important responsibilities as Chairman. During the next several weeks and months I intend to get more deeply into each program area to verify personally that this is the best, most effective and efficient use of our new staffing. I would therefore like to reserve my option to make changes. I have been at the Commission I think a total of almost 8 weeks now, and my staff and I hope to (a) examine our budgets carefully and (b) work closely with the subcommittee as we finalize our resource allocations.

#### PREPARED STATEMENT

As I said at the beginning, I'm honored to be Chairman of the SEC. I think it is the most important time in the history of the country to have this job, and I will be delighted to answer any questions you might have. Thank you.

[The statement follows:]

#### PREPARED STATEMENT OF WILLIAM H. DONALDSON

Chairman Gregg, Ranking Member Hollings, and Members of the Subcommittee: Thank you for inviting me to testify today on behalf of the Securities and Exchange Commission in support of the President's fiscal 2004 budget request. The fiscal 2004 budget request of \$841.5 million is the largest amount ever requested for the SEC and comes on the heels of last year's appropriation, which was the largest single-year percentage increase ever provided to the Commission.

At the outset, I would like to take this opportunity to thank you for the tremendous support and leadership you have shown in ensuring that the Commission receives the resources and staff necessary to fulfill its mission. Your backing, along with the strong support of our authorizing committees, demonstrates convincingly that the Congress is dedicated to ensuring the financial integrity and vitality of our markets. While recent events have shaken investor confidence in the financial reporting by public companies and the integrity of our securities markets, your support of the SEC in both fiscal 2003 and 2004, and the landmark Sarbanes-Oxley Act, will help reinforce the foundations of our markets and demonstrate their resiliency.

Although I have been at the Commission only since February 18th, I look forward to continuing and building on the strong and cooperative relationship that our Agency has developed with you in the past as we work together on the SEC's resource needs to implement the Sarbanes-Oxley Act and fulfill all of our statutory duties. This is a critical time for the agency and the way we address the challenges before us will determine not only where we go tomorrow, but for years to come.

In many ways, it may be time for the SEC to go through a transition—much like the transition that the U.S. military has experienced in recent years—and evolve into a much more efficient force, becoming quicker, more agile, and more pro-active.

I am now reviewing with senior staff the Agency's operations and resource needs to determine appropriate changes to address both our internal and external needs. My hope is that the SEC can develop a new approach to our mission, as the military has done, so that we can play offense more often, be more pro-active, and anticipate the problems we may face.

#### FISCAL 2003

Although this hearing is for the Commission's 2004 appropriations request, I believe it is necessary to put this request in the context of our fiscal 2003 funding level. Thanks to your efforts, the Commission was appropriated \$716.4 million to fund its operations this year as part of the recent omnibus appropriation. These funds will enable us to meet the remaining fast-approaching deadlines of the Sarbanes-Oxley Act, hire over 800 new staff, advance initial start-up funds to the Public Company Accounting Oversight Board, improve our training efforts, and address our most pressing information technology needs. We will continue each of these activities in fiscal 2004 and for that reason I would like to discuss them now.

#### *Additional Staff*

The new staff provided in fiscal 2003 will focus equally on the complex issues that we currently face and on the fundamentals upon which the Commission was built: full disclosure, fairness, transparency, and investor protection. Investor confidence is predicated on "minding our knitting" in these core areas. I believe that any budget increases we receive must be targeted to the programs and activities that will have the largest impact on our mission. In this regard, the budget that was prepared prior to my arrival calls for the following staffing increases in our major program areas:

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My initial review of these numbers suggests that overall this level of increase is warranted. However, during the next several weeks and months I intend to delve more deeply into each program area to verify personally that this is the best and most effective and efficient use of our new staffing. I would therefore like to reserve my option to make changes.

As discussed below, we will hire aggressively but thoughtfully, not just to increase head-count. As a result, these hiring targets may only be met over a longer period of time, but they will be met with people that we are sure can perform the vital tasks that we assign to them. And we are committed to train and integrate new staff as we bring them on. We are grateful that legislation has been introduced in both the House and Senate to help the Commission expedite and streamline the hiring process so that we can bring on additional, mission-critical securities industry accountants, compliance examiners and economists as quickly as possible to get on with the business of protecting America's investors.<sup>1</sup> The Commission strongly supports this legislation and hopes that it will be adopted at the soonest possible time and signed into law by the President. Without this expedited hiring authority, the Commission will not be able to hire the additional staff it needs—and which the Sarbanes/Oxley Act contemplates—in any responsive time frame.

Today, over half of all U.S. households are invested in our capital markets. Twenty years ago, that rate was less than 20 percent. Just to use one example: mutual fund investments today exceed by more than \$2 trillion the amount on deposit at commercial banks and are approaching the approximately \$7 trillion in total financial assets in the commercial banking system. The SEC has only 354 examiners to oversee these mutual funds and investment advisers. In addition, while there are over 7,800 registered broker-dealers—with more than 88,200 broker-dealer branch offices—in the United States, the SEC's broker-dealer examination program has only 218 staff to conduct inspections of these institutions. These facts, along with the accounting scandals that have plagued us, reinforce what we all know: our markets have changed, and grown, dramatically, investor confidence has been shaken, and the SEC must act decisively to deal with these challenges.

<sup>1</sup> See H.R. 658/S. 496, "The Accountant, Compliance, and Enforcement Staffing Act of 2003".

Equally important, I believe that the efficient functioning of the SEC is as much a part of investor protection as ushering in new rules and regulations. I have presided over similar management challenges while in the private sector and seen first hand what it takes to grow rapidly and responsibly and improve performance. The organizational and cultural changes that accompany the opportunity you have provided me are significant and require regular attention. Toward this end, the yardstick for measuring our success will be based both on the number and quality of immediate program improvements and on meeting the agency's long-term goals of investor protection and market strength. Two operational areas that play a significant role in this regard are staff training and management accountability.

#### *Training and Management*

New staff and the need for regular training go hand-in-hand. For this reason, the Commission will increase significantly its emphasis on frequent, in-depth staff training. Given the challenges we face, we need to ensure that staff continue to have the tools and skills necessary to fulfill their duties effectively. We cannot afford to have our most skilled employees leave the agency or be underutilized. Pay parity and the downturn in the economy have helped attract top talent, but there is more that we can do.

Management accountability is also central to our ability to perform our duties. I intend to enhance the Commission's operations by establishing a system to better train, evaluate, develop, and mentor managers and supervisors. This effort is consistent with the goals of the President's management agenda and is the right thing to do. We cannot expect SEC staff to successfully fulfill their duties if they do not have supervisors with the skills and tools to lead them. We must set expectations and reward our managers and staff accordingly.

#### *Information Technology*

The Commission's operational challenges also extend to our information technology program. Prior to enactment of our fiscal 2003 appropriation, our Office of Information Technology had been structured to maintain our existing information technology systems, undertake a few smaller projects each year, and complete only one large-scale initiative at a time. We have accomplished this level of activity primarily by developing a robust information technology capital planning program and relying heavily on contractors and outsourcing. This approach has been essential given past resource constraints, but it has left us with badly outdated IT capabilities. We must now be critically introspective, bring in broad IT expertise to evaluate our needs and further increase the involvement of our agency's divisions and offices in our information technology decisions. To meet our needs, program staff must work side-by-side with a reinforced information technology staff, and we must increase the number of information technology program managers we have available to assist the program offices in developing major applications to improve our effectiveness. While these hiring and cultural changes may not appear revolutionary, they are nonetheless significant and multi-year in nature, especially when viewed against our current inventory of major information technology needs.

The fiscal 2003 funding level allows the SEC to undertake three new major, multi-year information technology projects. The first one addresses the Commission's need to move away from paper documents. It is the development of a robust document management and imaging system that will make it easier for our attorneys, examiners, and others to cull through the tremendous volumes of information that they review and file as part of their investigative, inspection, and enforcement activities. This system will provide agency-wide electronic capture, search, and retrieval of all investigative and examination materials and will be designed to meet the demands of our document-intensive litigation program, and to assist our examination staff in analyzing the content of documents more effectively.

As an aside, one of the first things I noticed when I arrived at the Commission's headquarters and walked around was the extent to which the SEC is physically drowning in paper files. We need to make it easier for staff to do their jobs and to share information with each other. Document management and imaging are key components of this and, while it will be a multi-year effort, it is long overdue.

The second project holds equal potential to improve the efficiency and effectiveness of the Commission: a comprehensive change in our filing and disclosure processes, especially regarding financial reporting. The effort to improve the filing and transparency of public company disclosures is expected to lead to significant business process changes that will result in the elimination of confusing forms, the collection of uniform data from filers, and internal operations improvements that will allow staff to conduct more rigorous financial, industry-specific, and comparative analyses. Although this project will be carried out by issuers, their accountants and

their other advisors, under the leadership of the SEC, the principal beneficiaries of this initiative ultimately will be the nation's investors, who will have more understandable and reliable financial information upon which to base their investment decisions. This will result in a fundamental improvement in the transparency and comparability of firms' financial statements, which should significantly increase investor confidence.

When the agency's electronic filing system (EDGAR) was originally created, it did a terrific job of converting paper disclosures and filings into electronic documents and making more information available to the public. We now need to take the next step. As part of a comprehensive review of our business processes, we need to change how we work and alter EDGAR accordingly. We need to revisit what information staff must have readily available to conduct more intensive and robust disclosure reviews. For instance, while we receive and archive the EDGAR data, we cannot immediately analyze them. Instead, we depend on outside vendors to transfer the numbers in the text of the filings to machine-readable form that we can then analyze. We are in the process of designing tags for EDGAR filings that would allow anybody to extract machine-readable data from them. These initiatives will allow us to conduct analyses and monitor trends in real-time.

Our third major information technology requirement is to enhance our disaster recovery program. The SEC learned first-hand from the events of 9/11 and the experiences of its Northeast Regional Office, in New York, of the importance of keeping its data even more secure than it already is. In addition, we need to have the capacity to store and move large amounts of data from one regional or district office to another without first going through Washington. We need to move to a true "point to point" information technology system that allows us to mitigate the loss of data and to recover quickly in the event that we need to implement our continuity of operations plan. When this project is complete, the agency's critical files and information systems will be backed up daily and in multiple locations.

#### *Sarbanes-Oxley Act*

Since enactment of the landmark Sarbanes-Oxley Act last summer, the Commission has worked vigilantly to meet the Act's timeline and mandates. Within 30 days of the Act's signing, we adopted rules requiring CEOs and CFOs to certify their financial statements and accelerating insider transaction reporting to two days.

This past January was the busiest month of rulemaking in the history of the SEC. We adopted nine other Sarbanes-Oxley mandated rules relating to: Pro-forma financial information, codes of ethics for senior executives, financial experts on audit committees, trading during pension fund blackout periods, disclosure of material off-balance sheet transactions, retention of audit records, independence standards for public company auditors, standards of conduct for corporate attorneys, and the application of certain Sarbanes-Oxley certification and disclosure requirements to registered investment companies.

In addition, we sent four separate studies to Congress related to: Penalties and disgorgements in our enforcement cases, securities professionals who have "aided and abetted" federal securities law violations, commission enforcement actions involving reporting violations and restatements, and the role and function of credit rating agencies.

We met these deadlines without sacrificing our other work or obligations—including our robust enforcement program and numerous regulatory initiatives unrelated to Sarbanes-Oxley. For example, in January we also adopted rules regarding proxy voting by investment companies and investment advisers, and in February we adopted rules regarding analyst certification of research reports. And we're hard at work on other rules and studies, including rules related to: Improper influence on auditors, listing standards related to audit committees, governance of the Public Company Accounting Oversight Board, investment adviser and investment company compliance policies, public company internal control reports, critical accounting policies, and expanded current reporting.

#### *Public Company Accounting Oversight Board*

##### *Selection of a new chairman*

The Commission recently announced that it adopted a plan to select a Chairman of the Public Company Accounting Oversight Board established pursuant to the Sarbanes-Oxley Act of 2002.<sup>2</sup> The plan calls for the Chairman, the Commissioners, and the staff to reach out and solicit input from a variety of sources, including key mem-

<sup>2</sup> See "Statement of the Commission Regarding Selection Process for Chairperson of the Public Company Accounting Oversight Board (PCAOB)" March 4, 2003, <http://www.sec.gov/news/press/2003-28.htm>.

bers of Congress, investor advocates, academics, and members of the business community.

As I said in my confirmation hearing before the Senate Banking Committee, the selection of a Chairperson for the Public Company Accounting Oversight Board is my number one priority, and I am pleased that the Commission has been able to build upon the recommendations of the General Accounting Office and quickly devise a thorough and expeditious process to identify and vet potential candidates.

The SEC staff will incorporate new suggestions, update the list of qualified candidates and circulate it to the members of the Commission. The Chairman and the Commissioners will narrow that list based on the criteria in the Sarbanes-Oxley legislation, additional criteria that the Commission finds desirable, but not mandatory, and the individual's willingness to serve.

Each candidate on the narrowed list will undergo a preliminary vetting process. Upon completion, each member of the Commission will interview the leading candidates and a thorough background review will be completed. Following this review and consultation with the Chairman of the Federal Reserve and Secretary of the Treasury, as required, the Commission will vote to approve the appointment of a Chairperson.

The Commission will be looking for an individual who has experience running a dynamic and innovative organization; is well recognized by those participating in the financial markets and possesses a keen understanding of those markets; is independent from any particular constituency; has experience that demonstrates an understanding of the role of auditors in the Commission's financial accounting and disclosure system; has no known impediments or controversies that might impair his or her ability to lead, or the public's ability to rely on the individual to lead; and is willing and able to serve a five-year term.

In addition, we are seeking a person who has the ability to consider impartially ideas, information, and data from all sources, to seek additional input whenever it appears necessary, and to make timely decisions, as well as the ability to absorb complex information, analyze it objectively, and make rational decisions. Of course, we want someone who has the ability to communicate effectively, has a demonstrated commitment to public service and to the PCAOB's mission, as well as an awareness of the financial reporting and auditing environment. The individual we choose should have a demonstrated ability to create a collegial working environment and instill public trust.

My hope and expectation is that the Commission will move expeditiously and select a new chairman for the PCAOB as quickly as the process allows.

#### *Funding advance*

The fiscal 2003 budget provides the resources necessary for the Commission to advance start-up funds to the Board. The Commission initially advanced \$1.9 million to the Board on January 15, 2003. On March 28, the Commission approved a more substantial second advance of \$13.5 million that will fund the Board's operations through May and allow them to begin the development of state-of-the-art information systems to be used in their registration, billing and collection, and professional oversight programs. The Board has stated its intention to repay all of these funds to the Commission by the end of the current fiscal year.

#### *Commission Oversight*

The Commission has significant responsibilities related to the oversight of the Board, including approving the Board's budget and rules and adjudicating appeals from the Board's decisions on registration, inspection, and disciplinary matters. We have developed close communications and a good working relationship. For example, the Board and the Commission recently participated in a roundtable on issues related to the Board's registration and oversight of foreign accounting firms.

#### *Utilization of Commission Resources*

We have tremendous needs for the new resources made available in 2003 and have plans in place to meet these needs. However, I want to be sure—and I am committed to making sure—that every penny of that new money is spent wisely. I am determined that we take an aggressive but thoughtful approach to resource allocation. We will bring on the people we need to help us fulfill our mission, and not simply increase our head-count. I view this allocation of resources and renewed commitment to the SEC's needs as a multi-year effort to ensure that we make long-lasting and substantial improvements in the SEC's programs that will restore confidence and benefit our nation's investors.

The President's request for \$841.5 million in fiscal 2004 recognizes that the Commission's needs are growing and ongoing. As I stated earlier, this request is the largest amount the Commission has ever received and will allow us to continue all of the efforts that we are undertaking in fiscal 2003. In particular, it will allow us to focus further on financial frauds, review of public company filings, our new risk-based examination program, and the ongoing requirements of the Sarbanes-Oxley Act.

#### *Enforcement Activities*

The Commission has played, and will continue to play, a vital role in protecting our markets from fraud, manipulation and other practices that continually threaten to undermine their integrity. To meet the challenges facing us—including the unprecedented number of significant financial frauds and accounting failures, new securities products, technologies, and globalization—the Commission's enforcement program will continue to add personnel, including investigative attorneys, accountants, and market surveillance specialists.

The Commission has responded swiftly to the recent rash of accounting failures. In fiscal 2002, approximately 27 percent of all filed enforcement actions involved financial disclosure and issuer reporting violations. Financial reporting and accounting cases remain our number one enforcement priority, and numerous financial fraud investigations are currently underway. These types of investigations require a significant commitment of staff resources because they are fact- and document-intensive and include reviews of the conduct of a variety of individuals and entities. The Commission's enforcement program will continue to need additional attorneys and accountants to assist in these complex financial fraud investigations.

As the Commission seeks to aggressively investigate and punish corporate fraud, an increasing number of defendants are choosing to litigate. Even many cases that are ultimately settled are the subject of protracted litigation prior to settlement. Commission litigators are now actively involved in nearly one-half of recently filed cases. In addition, our litigation and investigative staff are increasingly involved in emergency court actions in an attempt to secure investor funds before they are lost forever and to alert the investing public to false and misleading disclosures being made by issuers. It is critical that the Commission maintain a strong litigation capability because it is the credible threat of litigation that allows us to pursue wrongdoers effectively and win our cases or settle them on favorable terms.

Additionally, the growing internationalization of the securities industry and the securities markets has added new challenges for the Commission in combating securities fraud. An increasing number of the SEC's enforcement cases have substantial international dimensions that make it more important for the Commission to work closely with its international counterparts in enforcement and inspection activities. Our staff devotes much time and resources to tracking down assets that have been sent abroad.

And finally, the Commission's enforcement staff works closely with U.S. Attorneys' Offices and the Department of Justice to obtain criminal sanctions as appropriate. This association was recently institutionalized by President Bush when he created Corporate Fraud Task Force, of which the Commission is a member and the Department of Justice heads. We also will continue to detail enforcement staff, in appropriate situations, to U.S. Attorneys' Offices around the country to support criminal prosecution of securities fraud.

#### *Market Structure Issues*

The rules governing trading within equity markets and the relationship among competing equity markets is another area that the Commission will focus on this year. Aware that such issues were coming to a head, the Commission organized two full days of market structure hearings in October and November 2002. Participants at the hearings included senior staff members of the New York Stock Exchange, Nasdaq, American Stock Exchange, and Chicago Stock Exchange; market makers, specialists, Electronic Communication Networks, and agency brokers; buy-side traders; representatives of individual investors; and respected academics. In the remainder of this fiscal year, the Commission will devote significant resources to the development, proposal, adoption, and enforcement of the policy actions that will be necessary in this area.

#### *Review of Filings of Public Companies*

The Division of Corporation Finance has been enhancing its selective review program to target issuers whose review would most protect investors—large companies, companies in critical sectors, companies that present particular perceived financial

or disclosure risks. This targeted approach is consistent with the directives contained in the Sarbanes-Oxley Act. The review of the Fortune 500 companies undertaken last year is an example of this approach. As review resources and technological enhancements that will assist in the assessment of risk are added to the Division, the review process will become more robust. While the review process cannot eliminate or identify all financial fraud or identify those who are determined to commit fraud, the review process will better fulfill its objectives of improving disclosure and deterring fraud.

The review process is increasingly focusing on financial reporting and financial disclosure because these are the areas where defective disclosure puts investors at most risk. To permit this focus, recruiting and hiring of review staff will emphasize accountants and those who are able to perform financial reviews.

The Sarbanes-Oxley Act also requires review of each reporting company at least once every three years. We are in the process of developing review processes that will permit us to meet that goal. Here too, the additional resources that we are adding to the Division are an essential element and will allow us to satisfy that mandate over a multi-year period. We will also use those resources to meet that review requirement in an efficient and effective way, and we intend to do so in a manner that does not undercut our investor protection objective.

#### *Risk-Based Examinations*

With the additional staffing provided in fiscal 2003, the Commission's examination and inspection staff will be able to implement our new enhanced risk-based inspection program. For investment advisers and mutual funds, this enhanced program will allow examiners to recognize the different levels of risk inherent in the operations, management, and compliance processes of investment advisers and funds. In particular, those registrants that have relatively higher risk profiles will be examined every two years, while all remaining firms will be examined no less frequently than every four years. New firms will be inspected within the first year of their operation. These more frequent inspections are a substantial improvement over the five-year inspection cycle used to schedule inspections prior to fiscal 2003. For broker-dealers, the new staffing levels will allow us to increase substantially our oversight of the risk management and internal controls of the largest broker-dealers that have the most customer accounts, and also to increase the small number of broker-dealer branch office inspections that we are currently able to conduct.

#### *Other Sarbanes-Oxley Act Requirements*

While the Commission has made tremendous progress in implementing many of the critical components of the Sarbanes-Oxley Act and has met each of its statutory deadlines, important initiatives and additional rulemaking pursuant to this historic legislation will continue to be a top priority for the SEC. In addition to the numerous substantive rules already adopted, a number of Commission actions are still mandated by deadlines set within the Sarbanes-Oxley Act. These forthcoming SEC actions include: the ratification of key rules and procedures for the Public Company Accounting Oversight Board; the adoption of rules on analyst conflicts of interest; the recognition of generally accepted accounting standards; as well as studies and reports relating to both principles-based accounting and off-balance sheet transactions and special purpose entities. I am confident that the Commission and its dedicated staff will continue to work tirelessly to implement these remaining provisions of the Sarbanes-Oxley Act.

Other rulemakings under the Sarbanes-Oxley Act, although not limited to a statutory deadline, also will play an important role in improving investor confidence in the credibility of reported financial information. For example, management and auditor reports on an issuer's quality controls over its accounting and financial reporting systems may enhance the quality and implementation of those controls, which, in turn, should improve the quality of financial reports and audits.

Another important area that will require the use of more Commission resources is international affairs. The development of international accounting, auditing, disclosure and enforcement standards is gaining momentum and will require more monitoring of and participation in international bodies that are promulgating and interpreting standards that could impact the credibility of information used by American investors.

#### CONCLUSION

In closing, let me reiterate how honored I am to serve as Chairman of the Commission at this time of great opportunity. Thank you again for inviting me today to speak on behalf of the needs of the investing public. I would be happy to answer any questions that you may have.

## PAY PARITY

Senator GREGG. Well, thank you, Chairman Donaldson. I have a couple of questions. First, after considerable effort we were able to get pay parity in place for the SEC. I'm wondering how it is working, whether you think it is going to allow you to attract the types of individuals you need and keep the individuals who are there and who are critical. You are in a business which, up until a few years ago at least, was extremely competitive for staff, although now you may be able to find staff with a little more ease. Our concern is that the SEC retain its caliber staff. Is there something further we should do, or is pay parity working?

Mr. DONALDSON. Well, I think, bottom line, pay parity is working. We probably have had too short a period of time to measure, but just to give you some numbers, our attrition rate before pay parity was averaging around 14 percent, and our latest figures indicate that it's 4 percent or less right now, so so far, so good. There are other items associated with the hiring of professionals which maybe we can get into, but as far as pay parity, it seems to be working. It's a tremendous help.

## HEDGE FUNDS

Senator GREGG. A question in another area, hedge funds are sort of viewed as the Wild West of the investing community these days, especially Wall Street. I'm wondering if the SEC has any concerns about whether or not we need additional, or whether or not you intend to propose additional, regulatory activity in the area of hedge funds and accounting disclosures and activities there.

Mr. DONALDSON. Clearly, the whole area of hedge funds is one in which we need to have more information. The latest numbers indicate that there are some 6,000 hedge funds in operation right now, with some \$600 billion under management. The money is flowing in. The growth in hedge funds over the last decade has been considerable.

I would stop and say that I think there's a slight misnomer that the name hedge fund implies. Many of the funds that are classified as hedge funds are not hedged at all, they're simply investment pools, but let's use that term.

I think our posture on this is that the SEC has been, before I got to the SEC, attempting to get information about hedge funds, and since I've arrived we have initiated what will be a roundtable discussion in May for 2 days in which we're inviting a broad cross section of people associated with hedge funds and so forth to come in and tell us about what they're doing. So by the end of May we'll have a lot more information.

I would say generally that we just need to know more about the techniques that are being used by hedge funds. We need to know more than we know now about who is investing in these funds. By and large they are unregulated by the SEC. Some are regulated under the Investment Advisors Act. We see some trends in terms of what I would call the retailization of hedge funds, that is, the putting together of groups of smaller investors, which is something I think we have to examine.

Up until now, by and large, you've had to have certain investable assets and certain income levels in order to be invested in these funds, and in order for the funds to maintain their nonreporting status, and I think that game has shifted. So I think it's too early for us to make a judgment, but we're going to put some resources into looking at that so the next time you ask that question we can give you a good answer.

Senator GREGG. Well, following up on that, from what you said I understand you are still early into this issue, but what do you see is the basic risk that you would be concerned about from the standpoint of protecting the public relative to hedge funds?

Mr. DONALDSON. Well, as you well know, there was a serious risk that almost caused a financial collapse in the case of Long-Term Capital Management, which was a particular kind of hedge fund that employed macroinvestment decisions and heavy leverage. That was a great concern when the markets turned against them, and I think the U.S. Government did a terrific job of stepping in with the Treasury Department and the Federal Reserve, and basically avoiding a collapse that could have been very damaging to other people.

Right now, I think that area has been well covered. The area of potential risk now is the new entrants into the field that we see as Wall Street has had its problems here in the last 3 or 4 years. We see a lot of people breaking off from Wall Street firms, from investment counseling firms, and setting up hedge funds—one or two people raising money for those hedge funds—so you have a lot of potential here for inexperienced people with a totally unregulated vehicle getting themselves in trouble.

We don't know how much leverage is being used in some of these funds. We need to know more about that. We need to know more about some of the trading techniques, so that I think right now all I can say is that we need to know more about what's going on.

Senator GREGG. Senator Hollings.

#### STATUS OF ENRON CASE

Senator HOLLINGS. Chairman Donaldson, we are very lucky, in my opinion, to have you take this particular assignment, because everyone has confidence in you.

I want to ask about two touchy things, one on the Kenneth Lay case. The reason I ask is, we had the Attorney General just the other day, and he appears before us and he relates all of the hard-charging comedown on corporate corruption, we've cleaned up corporate corruption in this Government of ours and everything else, and he listed the cases and what-have-you, and then when you ask about the leading case that we all know about, Kenneth Lay, he said, wait a minute, I've recused myself, I don't know anything about it. Do you?

I mean, they've made reports to the Securities and Exchange Commission, and you're the Chairman. I hope you haven't recused yourself. Kenny boy didn't give you a contribution, did he?

Mr. DONALDSON. Let me say what I can say.

Senator HOLLINGS. The reason we're interested in this is, right to the point, we as good lawyers know how you can bring—we've defended the charges and we've brought charges and assisted in

the prosecution. Before the Commerce Committee the entire California crowd appeared, and the authorities just listed out the fraud and how it was conducted, whereby they would ask for way more than their allocation in energy shortages and then take the excess of that allocation and ship it out, ship it back in and get it at the higher price because it was imported and what-have-you.

So I said, well, wait a minute now, referring to Mr. Lay and Enron knowing about it, I said, I remember specifically earlier this morning Ms. Lay appeared on my TV and said her husband didn't know anything about it, and Mr. Freeman was the witness. He said, the dickens he didn't, he knew everything about it. He was running it. He was in charge.

So you know, there are a lot of things about knowledge and what-have-you, but here you've got testimony before the Congress that they knew it, and it was a fraud, and California now has brought suit for \$7 billion or \$8 billion, whatever it is, for reimbursement, but we don't ever hear anything, and 1½ years has passed, and we all are proud about how we have come down hard on corporate corruption, but all of a sudden this case disappears.

In the meantime, back at the ranch, they said, wait a minute, you know, the fellow in charge of corporate corruption was out of the law firm that represented Enron, namely Mr. Larry Thompson, so what gives here? I mean, I'm trying to find out the status of that case.

Mr. DONALDSON. Well, you bring up a number of issues; there is the criminal case, and there is the civil case. Just to give you a little background, the Enron criminal investigation is being led by the Enron Task Force, and that was formed in January of 2002 to investigate all the matters related to Enron, and it is overseen by President Bush's Corporate Fraud Task Force which includes us, the SEC, and the Department of Justice. It is a team of federal prosecutors supervised by the Criminal Division and agents of the FBI and the IRS Criminal Division.

That task force also has coordinated with and received considerable assistance from the Securities and Exchange Commission. Now, as far as the civil case is concerned, last August the SEC filed a case against Michael Kopper, who is a former top Enron official accused of violating antifraud provisions, and then in October we filed a case against Andrew Fastow, who is Enron's former CFO, alleging violations of the antifraud, periodic reporting, books and records provisions and so forth.

Most recently, last month the Commission charged Kevin A. Howard, the former chief financial officer, and Michael W. Krautz, the former senior director of accounting of Enron Broadband Services, and also March 17, charged Merrill Lynch & Company and four of its former senior executives with aiding and abetting Enron securities fraud. Now, that is the first time that the SEC has brought an aider and abettor action against a bank.

Now, as far as a general comment on your question specifically referring to Lay—

Senator HOLLINGS. He was the chief executive officer.

Mr. DONALDSON. He was the chief executive officer, and I think I can say that the coordination of the criminal and civil action requires a lot of very careful building blocks, if I can put it that way.

Senator HOLLINGS. You are building a case, is what you're saying?

Mr. DONALDSON. The building blocks have to do with the way the criminal justice system works. It has to do with the way information is received. Information can be received by the Justice Department a little more completely than it can by us. I guess what I'm saying is, without commenting specifically on that case, that we're on the case of all the Enron activities.

#### EXPENSING STOCK OPTIONS

Senator HOLLINGS. If Mr. Donaldson says you're on the case, that's sufficient for me. Let me ask this, and go to another thing that Arthur Levitt, when he was the Chairman, he tried to get these stock options expensed. We tried to, Senator Levin from Michigan, he put in an amendment. We were all ready to vote on the amendment, then all of a sudden the majority leader and the minority leader said no, we are not going to take—we're going to take it up later, and later is 1 year ago I think, and we haven't ever taken it up.

I got right to the point with WorldCom, and one of the officials I'm asking, I'm saying how in the Lord's world did you give Ebberts a \$400 million loan, and the answer was, we had to. I said, you had to? He said, yeah, he had all of these options and he had built them up and built them up, and he had them, and he was going to cash them in twofold. He was going to ruin the financing we had on course for WorldCom-MCI on the one hand and of course destroy the value of the stock, so we had to give it.

Corporate governance shouldn't work itself into that kind of cul-de-sac, and we're ready to do it, and I have heard, I believe, your comment that they should be expensed. You can't do it both ways. They are an expense, but they're not one. What is the position that the Securities and Exchange Commission has taken? What is being done? Do you want us to write it into this bill? I would be glad to try to write it in here that we expensed the stock options so we can really get corporate governance back. That was the real thing, and it's still bothering us, these excessive executive salaries.

We had to write on the bill just the day before yesterday, or last week I guess it was, Friday, that here we were financing the airlines \$3.5 billion. All the airlines' stock, net worth of all the airlines does not come up to \$3.5 billion. We've given them more money than they are all worth if you put them all together, and we said well, that's pretty bad, but even worse is, look at these bonuses they are giving, these millions and millions of dollars of bonuses as they all go broke, rewards for going broke. This is what's ruining—nobody wants to invest in a stock market that's got those kind of stock options on the one hand and financing companies giving excessive bonuses and everything else like that on the other hand for going broke. That's the problem that you have.

Mr. DONALDSON. Well, let me make just a couple of comments. I have made, as you allude to, comments on this subject during my confirmation hearing, and I will state again unequivocally that I believe that stock options are an expense and that that expense needs to be reflected. That is point number one.

Point number two, and the more difficult question, is how to do it? How do you come up with a value? In a complex situation in terms of valuing those options over differing periods of years and so forth, and different markets, what is the value that should be reflected on the day that those options are given? A lot of them expire with no value. A lot of them are tremendously valuable. How do you rate that? How do you do it?

The FASB has committed themselves now to come up with a formula for expensing those options and an accounting standard for doing so, and I'm going to be very interested to see that standard. It is not an easy calculation, but they have committed themselves.

Senator HOLLINGS. Will that be a rule of the Commission, then, once they make that recommendation?

Mr. DONALDSON. As you know, under the new arrangement with the Public Accounting Board, we will both be very much listening to the rules proposed by FASB. I think we are going to see that your desires are fulfilled here.

Senator HOLLINGS. And your desires.

Mr. DONALDSON. And my desires, absolutely.

Senator HOLLINGS. Thank you very much, Mr. Chairman.

Senator GREGG. That will have a tax effect too. Will the Treasury be included in that exercise?

Mr. DONALDSON. The final rule will be an accounting rule, and our new oversight board with the primary responsibility at the first level will be there, but of course their rulings and so forth come through us and have to be approved by us, so we will have the ultimate responsibility.

#### PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Senator GREGG. How about this accounting board? How are you doing in getting that going, and especially what are we going to pay these people, talking about pay?

Mr. DONALDSON. As to the status of the Board, as I've said publicly, it is a number one priority for me as the new SEC Chairman to get the right person to be Chairman of the Accounting Board. Although I'm saying me, it ultimately is our Commission that will appoint that chairman.

We instituted a process within 1 week of my arrival, a process for searching for that person. I will not bore you with all the details of the process, except to say that we reached out in a broad and public way to add to our list. We talked to anybody and everybody that would talk to us about making suggestions. We brought in a tremendous number of names. We then had a time-phased process that boiled that down.

We have boiled it down. We are in an advanced stage now, and I think that what I would say is that for anybody that has been in the recruiting business, if you will, we don't want to make a mistake on this. We want to get the right person, and generally speaking, the right person is not always readily available.

Again, my experience has been that oftentimes the right person is happily doing something else, and so it is a recruiting effort to get the right person to come. But I am encouraged by the work to date, and I think presently we will have somebody, sooner, I hope, than later.

Senator GREGG. Not to be parochial about this, but you're the right person for the SEC. You would probably be the right person for this board also, and obviously in taking the SEC job you're not getting paid a lot of money compared to what you made in the private sector. Yet the salary for this accounting board is being set at like \$500,000, which is about twice what we pay the President.

Mr. DONALDSON. I can tell you what the relationship is to my salary.

Senator GREGG. Your salary and my salary. The Chief Justice of the Supreme Court is paid about \$160,000, I think. I'm not sure that it is understandable why we need to pay so much. I mean, isn't the person who takes this job going to be mostly doing it as a public service, as you are doing your job, as the President does his, and we hopefully do ours, and as the Chief Justice of the Supreme Court does his?

Mr. DONALDSON. Well, I understand exactly what you're saying, and I think you have to go into the history, which you probably know better than I do, of the Sarbanes-Oxley legislation and what went into the status of the Public Company Accounting Oversight Board, and it is not a Government agency. It was set up as an independent privately incorporated agency.

Senator HOLLINGS. Why?

Mr. DONALDSON. The reason for that, and again I'm speculating on this because I had nothing to do with establishing it, was that there are a lot of other entities out there in the private sector such as the FASB and other entities like that, which are attracting people to work there with private sector compensation. And I think the intention of Sarbanes-Oxley was to be able to go out and get not only the members of the Board, but also to get staff members, who were competitive with the best people available out there. So the Oversight Board was ordered to set a salary level that was comparable to what would exist, not in total private sector America, but comparable organizations.

They did that and came up with that salary level. Actually it is slightly over \$500,000 for the Chairman and \$450,000, I think, for the members of the Board, and that received the kind of negative comments which you've expressed here.

I will stop there, except to say that they are doing what they were ordered to do. Whether they could have modified it or presented it in a better way remains to be seen.

Senator GREGG. I suspect the right person to do it won't do it just to make money.

Mr. DONALDSON. Excuse me, not to interrupt you, but I think you just don't know—I mean, you just don't know. You're absolutely right that certain people are not going to do it, but certain other people maybe will.

#### SARBANES-OXLEY ACT

Senator GREGG. On Sarbanes-Oxley, how is it working? It's 8 months into it. I hear grumbling. Maybe that's because it's working. Do you see issues out there that we're going to need to revisit?

Mr. DONALDSON. As you know, the SEC has been in an extensive rulemaking mode here, and we're coming to the end of that.

I think that so far, so good. I think that the system is working the way it should work, which is that a law is passed and the rule-making based on public comment and so forth can address some of the unintended consequences of the law, maintaining the spirit of the law, but being practical about the unintended consequences.

I think it is working quite well. If you go out into corporate America, particularly in the audit committee function, which is where some of the rules are most advanced, I think there's a heightened awareness of the responsibility of the audit committee.

There are still some issues that we have to cover by rulemaking, but I think it's working pretty well. I say pretty well because there's a lot of nervousness out in corporate America about just exactly what these rules mean. There's a lot of tentativeness, and that creates a kind of a distraction in my view for people running companies. They can become so tied up in trying to conform to the letter of the law that the risk here is that they lose flexibility and lose sight of what's needed to run an entrepreneurial company. That is a risk.

My own feeling in this is that—and I probably shouldn't say this—but I feel very strongly that we can pass all the laws that we want to, but we need the atmosphere inside the company to be moral. The philosophy of running the company should be that the chief executive and the board says this is the kind of company we want to be, and we're not going to skate right up to the minimum required by the letter of the law. We're going to stop well short of that because that's the kind of company we want to run, and until companies do that and have a code of ethics that is more than just written on paper, I think we will not have solved our problems.

I might go on to say that I think that there is a shift here, largely as a result of Sarbanes-Oxley, of the power, if you will, and authority to the board away from the chief executive who operates as he or she wants to. Gradually the boards of directors are recognizing that it is their responsibility to the shareholders to set that tone, and then to hire management that has the same feelings about the ethics of doing business.

#### EFFECT OF SARBANES-OXLEY ON CORPORATE DIRECTORS

Senator GREGG. I couldn't agree more with your explanation of the philosophy and how it should work. I'm wondering, however, if, with Sarbanes-Oxley and the litigation atmosphere, we haven't created a situation where the traditional director no longer wishes to serve on a board of directors. In that case, you're going to create an environment where you basically end up with professional directors who are willing to take risks. Taking risks is the way they make their money. This is, I think, one of the strengths of corporate America, which is that you get Main Street on your board of directors, and it may be a well-heeled Main Street, but at least it's Main Street. You talk to folks who serve as directors now and they're all scared, and many of them won't serve.

Mr. DONALDSON. This is a real problem, and I think there are two solutions to it at least. One is that the corporate directors themselves, the existing body of corporate directors are going to have to figure out how many boards they can be on to discharge their new obligations under Sarbanes-Oxley. They're going to have

to think through, and the boards are going to have to think through as they recruit, that there is an enhanced responsibility here and an enhanced risk, as you say, and I think potential directors and existing directors are going to have to look at that carefully.

Beyond that, I believe we're going to have to bring a whole new cadre of directors into the game. It's been a relatively small group of people who serve on many boards. That's been the tradition, a lot of CEOs serving on other CEOs' boards. There is a tremendous wealth of talent out there, out in corporate America and elsewhere, who can be very good corporate directors, and who have the time, and who will learn by doing it and bring new dimensions.

This makes me feel that we have to organize the training of these people, and searching for them, and we hope to be very active in that. I commend the number of business schools and law schools in the country, and the New York Stock Exchange, who are all moving toward director education, if you will. And we want to help them do that and intend to help them do that, so I think you are going to find a lot of, I'll say young people, but maybe older people who have not had a crack at it, who have something to offer and are willing to take that challenge. But we'll see.

Senator HOLLINGS. Along that line, just as an aside, when I was a young Governor from 1958 to 1962, that is what I had. My Bible was right there, Dun & Brad, and I could just pick out those corporate directors, and there wasn't any training. They were just drinking buddies. I mean, the GE served on the IBM, served on the General Motors, served on the Dupont. I mean, you could find them all. I wove them into what we called the plantation society. We've got over 100 plantations in the low country of South Carolina, and each Sunday at 11 o'clock they would have a brunch and go from one to the other, and I was always at those brunches to meet those folks and everything else, and then talk to them and try to get them to move their industry, try to carpetbag New Hampshire.

Senator GREGG. You did a good job of it, too.

Senator HOLLINGS. We had a good time doing it, but those corporate—they were good. They were good. I found all the CEOs and everything else very good, but it's gotten to the extreme. The quarterly reports and the life of a CEO is what, 3 years or something. He's got to get the stock up or they get him out, or whatever it is. They just take the money and run, all kind of bonuses, everything else like that. You've got a tough job trying to change that with the stock exchange and everything else and the business schools, as you indicate, working on it. You do a lot of good work. Thank you.

#### CONCLUSION

Senator GREGG. Do you have anything else you wish to add?

Mr. DONALDSON. Again, I'm delighted to be here.

Senator GREGG. The check is in the mail.

Mr. DONALDSON. I might just add one thing, if I can, which relates to the hiring of the people that we have to hire, we can hire lawyers quite easily because they don't have to go through the Civil Service posting and all of the competitive service requirements.

We are having real problems hiring accountants and economists and examiners. It is hard for us to compete out there under exist-

ing hiring regulations; therefore we have been working hard to see if we can't get those laws changed, and the House is ready to vote out an excepted service exception for us. By the way, our union has agreed with this, and we have sent a letter from myself and the head of the union, who cooperated with us. So—you asked if there was anything else you could do.

Senator GREGG. Well, we have been known to put authorizing language in our bill, so if you want to get us the language, and if we can get the agreement of Senator Shelby——

Senator HOLLINGS. That might help move it along. Any need like that, just contact the chairman.

Mr. DONALDSON. Well, I know it is not the direct jurisdiction of this committee, but it helps us.

Senator GREGG. Well, everything is in the jurisdiction of this committee. This is the Appropriations Committee.

Mr. DONALDSON. Okay.

Senator HOLLINGS. That's the way I was taught.

#### SUBCOMMITTEE RECESS

Senator GREGG. Thank you very much.

The next hearing is scheduled on Thursday, April 10, at 10 o'clock in this room, and at that time we will hear from the Director of the FBI.

[Whereupon, at 10:40 a.m., Tuesday, April 8, the subcommittee was recessed to reconvene subject to the call of the Chair.]